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Remarks of

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SECURITIES AND EXCHANGE COMMISSION
INITIATIVES REGARDING SECURITIES MARKET
REFORM AND BANK SECURITIES ACTIVITIES

The views expressed herein are those of Chairman Ruder and do not necessarily reflect those of the Commission, other Commissioners, or the staff.

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I. Introduction

It is a great pleasure to be here today to address the Section of Corporation, Banking and Business Law during your Annual Spring Meeting. The recent disruptions in the world's securities markets have placed special responsibilities upon all of us who are charged with market regulation duties. Other developments also have presented the Commission with important regulatory challenges. One of those developments -- the proposed repeal of the Glass-Steagall Act -- is particularly appropriate for discussion at a meeting of a section named, at least for the present, the Section of Corporation, Banking, and Business Law.

II. The October Market Break

The stock market break of last October, as well as market conditions since then, are of great concern to all of us. If you have been reading recent press reports, you may think that all the Commission is doing is preparing a hostile takeover for the CFTC. Let me assure you that our primary endeavor is to seek cooperative solutions to regulatory problems.

Our current markets can only be understood in the context of recent changes in institutional investment activity. During the last decade, institutions, including investment companies, have amassed ever larger portfolios of equity securities. Increasingly, institutions want to trade all or a portion of their portfolios, not just individual securities. The creation of index options and futures has made it possible, and relatively

cheap, to buy or sell the equivalent of a portfolio of securities. Use of the New York Stock Exchange's automated Designated Order Turnaround system, called DOT, has also made it possible to directly buy or sell, at the same time, an entire portfolio or "basket" of stocks.

Prior to October 19th, some institutions were using sophisticated index arbitrage and portfolio insurance strategies. Index arbitrage is the purchase (or sale) of stocks that comprise an index and the simultaneous sale (or purchase) of futures or options on that index. The purpose is to capture the difference between the value of the index and the collective value of the portfolio of stocks comprising the index. Arbitrage usually reduces differences in prices between the stock index futures and stock markets by pushing up prices in the market where the buying occurs and pushing down prices where the selling occurs. By helping to achieve closer price correlations between the stock index futures and stock markets, arbitrage facilitates the use of futures to protect or "hedge" the value of stock portfolios.

"Portfolio insurance" is a hedging strategy that was in widespread use before the October market break. Under one version of this strategy, stock index futures are sold when the value of the portfolio decreases a certain percentage. The sales of futures are thought to be less costly and quicker than the sale of stocks, offering a way of controlling risk for a broad-based portfolio in a declining market. If the futures markets

become congested and too costly, some portfolio insurance plans call for the sales of stock instead of futures.

With this as background, let me briefly describe the markets of last October. During the week before October 19, so-called Black Monday, the Dow Jones Industrial Average dropped 250 points. On Friday, October 16, the stock market had its first triple-digit loss, as the Dow declined 108 points on then-record volume of 344 million shares. Then, as you know, on Monday, October 19, the Dow fell 508 points on volume of more than 600 million shares. On October 20, volume also exceeded 600 million shares, in an extremely volatile market. On the 20th, the market rallied to close up 103 points, but only after a mid-day crisis during which the Dow dropped to a 1987 low of 1,708, more than 1,000 points and 37 percent below the August 25, 1987 all-time high of 2,722. During this mid-day period, a large number of blue chip stocks were closed for trading on the New York Stock Exchange, with large imbalances on the sell side.

What caused the market break? No one can be sure, but my view is that economic news and the Friday stock price decline created great selling pressure on a market which was ripe for a correction. This pressure was exacerbated on the 19th and 20th by large stock and futures sales by institutions pursuing a variety of arbitrage and portfolio insurance strategies. During certain critical trading periods on the 19th and 20th, index arbitrage or portfolio insurance, or both, accounted for between 30% and 65% of total New York Stock Exchange volume in the stocks

that comprise the S&P 500 index. Institutions holding multi-billion dollar portfolios simultaneously pursued similar strategies in a declining market, causing a rush for the exits that accelerated the decline and most probably extended it beyond levels that can be accounted for by fundamental economic factors alone.

Extreme stock price volatility continued through the end of October. While the markets are more stable now than last October, they remain more volatile than before the market crash, as the 140 point loss on January 8, 1988, vividly demonstrated.

Based on the detailed study of the market break made by our Division of Market Regulation, the Commission believes that our securities market is a linked market, formed by stock index futures, stock index options, and stocks. Further, under current conditions, new institutional trading mechanisms and strategies in this linked market can cause extraordinary peak volume and volatility.

The Commission has recommended three broad approaches for reform of the markets: (1) expanding the capacities of the markets; (2) increasing the coordination among the markets; and (3) retarding the volatility and volume of trading during crisis periods.

What specific steps can we take to expand the capacities of this new unified, and often turbulent, market? First, we are seeking to enhance the ability of our markets to handle trading volume surges. We are urging the stock exchanges to expand the

systems that receive orders electronically from brokerage firms and in some cases execute these orders automatically, so that markets do not falter during peak volume periods due to lack of physical capacity. I am pleased to report that a number of the stock exchanges already have increased capacities of their automatic order routing and execution systems. Newly established communication links between the stock, options, and futures exchanges also will enhance information exchange about market conditions.

A second important step is to increase the amount of market making capital available in the securities markets. Among other measures in this area, the Commission is:

- (1) examining the need to increase minimum specialist capital requirements;
- (2) encouraging market participants, including specialists, to review with their bankers the availability of additional liquid funds in emergency situations;
- (3) consulting with the Federal Reserve Board and the CFTC regarding capital availability for the stock, options, and futures markets; and
- (4) suggesting that the New York Stock Exchange consider creating special areas on its floor for the trading of entire baskets of stocks in order to relieve some of the strain on the specialists responsible for trading individual stocks.

Even after the capacities and capital of our integrated markets are enhanced, there still may be times when market mechanisms are under severe strain. The Commission is considering measures designed to retard the increased velocity and concentration of inter- and intra-market trading that in turn has increased the probability of wild price swings.

One approach to the volatility problem is to recognize that the increased intensity of market trading is due in part to the greater leverage of futures products. With low margins, large stock index futures positions can be established with a relatively small capital infusion, and then can be liquidated very quickly. In addition, the futures markets do not require physical settlement and do not have the short sale restrictions that exist in the stock markets.

One method of slowing the futures market, retarding excessive accumulations of futures positions, and reducing liquidity expectations would be to raise initial margins on stock index futures for non-market makers. The Commission has recommended that, at least temporarily, these margins be raised to levels harmonious with stock margin levels applicable to stock market professionals. This would mean initial futures margins of 20 to 25 percent instead of the current level of approximately 13 percent.

Other means of coping with market volatility have been suggested. The Commission currently has before it a rule proposal giving the New York Stock Exchange power to close its

DOT systems to program trading in volatile markets. Other solutions suggested in the various reports include imposing price limits in the futures markets, establishing procedures for coordinated inter-market trading halts, and delaying futures market openings until the stock markets are open. These topics and others offer a broad range of choice to deal with market problems.

Since October the Commission, the Commodity Futures Trading Commission, the Federal Reserve Board, and the securities and futures self-regulatory organizations have worked hard toward increasing cooperation and coordination. The agencies and the self-regulatory organizations have made progress on emergency communications and planning, and cooperative efforts in other areas continue. In this connection, on Friday of last week the President signed an Executive Order establishing the Working Group on Financial Markets, consisting of the Secretary of the Treasury and the Chairmen of the Securities and Exchange Commission, the Commodity Futures Trading Commission, and the Federal Reserve Board. The Working Group has been asked to review market conditions and solutions offered by various studies and reports in the areas of investor confidence, credit system issues, market mechanisms, and regulatory structure. I am hopeful that agreed solutions to many of the problems in those areas will be forthcoming as a result of cooperative efforts.

III. Glass-Steagall Reforms

In recent months, the Commission also has dealt with proposals to modify or repeal the Glass-Steagall Act in order to allow commercial banks to become full fledged competitors in the securities industry.

Originally the Glass-Steagall Act, enacted in 1933, strictly limited the extent to which banks could engage in securities broker-dealer, underwriting, or investment advisory activities. However, during the 1980s the barriers to securities activities by banks have been significantly eroded as a result of new interpretations of Glass-Steagall by banking regulators and by courts. Glass-Steagall -- once thought to be an impenetrable barrier to such activities -- is today a barrier full of gaping holes.

Because banks' securities activities are not subject to broker-dealer regulation, the expansion of these activities has concerned the Commission for some time. As a result, in 1985 the Commission adopted Rule 3b-9,^{1/} which was intended to fulfill the Commission's goal of achieving adequate and consistent regulation of securities activities of banks. The rule required any bank engaged in the business of effecting brokerage transactions, or dealing in or underwriting non-exempted securities to either register as a broker-dealer or enter into a contractual or other relationship under which a registered broker-dealer would in fact

^{1/} Securities Exchange Act Rel. No. 22205 (July 1, 1985), 50 F.R. 28385.

be the provider of such services. Following the Commission's adoption of Rule 3b-9, over 170 banks and bank holding companies established registered broker-dealer subsidiaries.

On November 4, 1986, the United States Court of Appeals for the District of Columbia Circuit held that the Commission did not have authority to promulgate Rule 3b-9.^{2/} However, the Court of Appeals was sympathetic to the goals which the Commission was seeking to achieve and suggested that the appropriate course would be for Congress to address the issue.

In May of 1987, at the request of the Commission, a bank broker-dealer bill was introduced in the Senate by Senator D'Amato and in the House by Congressman Markey. Little support for that legislation existed in Congress until recently.

In December 1987, the Commission was asked to testify concerning proposed legislation to repeal the Glass-Steagall Act. I delivered the Commission's strong message that it would be unable to support repeal of the Glass-Steagall Act unless the securities investor protection concerns arising from increased bank securities activities were simultaneously addressed. Our position was that banks must be required to conduct both their new and existing securities activities in separate securities affiliates, subject to Commission regulation.

In that December 3 testimony I urged that the following activities by banks should be permitted only in their securities

^{2/} See American Bankers Association v. Securities and Exchange Commission, 804 F.2d 739 (D.C. Cir. 1986).

affiliates, so that the activities would be subject to Commission regulation:

- (1) publicly-advertised brokerage;
- (2) brokerage services provided to advised accounts for which transaction-related compensation is received;
- (3) corporate securities dealing or underwriting, including private placements of securities;
- (4) municipal revenue bond underwriting and dealing;
- (5) sponsoring, underwriting, and distributing unit investment trusts; and
- (6) underwriting and distributing investment company securities.

Additionally, I urged that, if banks are permitted to underwrite and distribute investment company securities, the Investment Company Act and the Investment Advisers Act must be amended. Because the two Acts were drafted in the context of the separation between banking and securities mandated by Glass-Steagall, they do not adequately address the investor protection concerns that will arise if banks are permitted to engage generally in the investment company business. These concerns arise from bank custody of assets of affiliated investment companies, transactions between affiliates, investment company borrowing from affiliated banks, bank advising of investment companies, the independence of directors, and the use of a bank's name by an affiliated investment company.

On December 9, 1987, I testified before the House Banking Committee emphasizing again that the Commission would be unable to support repeal or modification of the Glass-Steagall Act unless the Commission's investor protection concerns were met.

Subsequently, at Senator Proxmire's request, the Commission staff met with the Federal bank regulators to draft legislative language addressing the Commission's investor protection concerns. Compromise language resulting from those meetings was included in the version of S. 1886, the Glass-Steagall reform bill sponsored by Senators Proxmire and Garn, that was approved on March 2nd by the Senate Banking Committee by a vote of 18 to 2. In order to achieve an agreement, the Commission had to make some significant concessions. Nevertheless, the compromise, taken as a whole, provides adequate investor protection, and provides significantly better protection for investors than that likely to exist if banks' securities activities increase through regulatory interpretation and court decisions.

Under the compromise, banks would be required to conduct all securities activities through broker-dealer subsidiaries or affiliates subject to certain limited exemptions.

First, a bank could conduct primary private placements, so long as sales were limited to certain types of institutions and to individuals with a net worth over \$5 million. This exclusion was intended to recognize banks' existing private placement activities, while limiting sales activities to customers with less need for regulatory protections. Banks dealing in privately

placed securities would be required to do so through securities affiliates.

Second, a bank could effect brokerage transactions for its traditional trust accounts, unless it both solicited this brokerage and received transaction-related compensation. For other bank fiduciary accounts, such as managed agency accounts, securities safekeeping accounts, and self-directed IRAs, a bank could provide brokerage only if it neither solicited the brokerage nor received transaction-related compensation. This exception permits banks to include brokerage transactions in normal fiduciary services, but attempts to ensure that banks cannot use so-called fiduciary services to evade broker-dealer regulation.

Third, a bank could engage in municipal revenue bond underwriting activities, but a bank with a securities underwriting affiliate would be required to conduct both general obligation and municipal revenue bond underwriting in a separate, registered broker-dealer. This provision strikes a balance between the desirability of having municipal bond underwriting activities conducted in broker-dealers and a desire to avoid imposing high costs upon municipal bond underwriting. This compromise deals as well with the contention that if banks can engage in general obligation bond underwriting without registration they should be able to do the same for municipal revenue bonds. In any event, municipal bond underwriting

activities conducted in banks will continue to be subject to antifraud and other protections.

Fourth, there would also be exceptions from securities regulation for (a) networking arrangements with broker-dealers, (b) sweep accounts, (c) transactions for employee benefit plans, (d) transactions for a bank's affiliates, and (e) banks effecting fewer than 1,000 transactions per year. These exceptions are all drawn from Rule 3b-9.

In the investment company area, the compromise seeks to permit traditional fiduciary advisory activities, but to subject the investment advisory activities to Investment Company and Investment Advisers Act provisions.

First, banks that advise investment companies would be required to register with the Commission as investment advisers and to be subject to Commission regulation and inspections. A bank, however, could register a separate department or division of the bank as an adviser. These provisions give the Commission adequate oversight over investment company advisory activities without disrupting banks' other operations.

Second, banks' custody and lending arrangements with affiliated investment companies would be permitted only in accordance with rules adopted by the Commission, after consultation with the bank regulators. This provision recognizes both conflict of interest and financial safety concerns.

Third, investment companies would be precluded from purchasing securities in an underwriting where some or all of the

proceeds would go to repay a borrowing from an affiliated bank entity, except that such activity could take place in conformity with Commission regulations. This is a fire wall provision also designed with conflicts and financial safety in mind.

Fourth, officers, directors, and employees of banks and other entities that provide services to or do business with a fund would be defined as "interested persons," bringing into play all of the restrictions associated with that term.

Fifth, the Commission would be given express additional authority to require disclosure concerning the absence of Federal deposit insurance for mutual funds.

The Commission now supports repeal of the Glass-Steagall Act but only if that repeal is accompanied by the investor protection amendments to S. 1886 worked out in the compromise between the Commission and the Federal banking agencies. Under these conditions, the Commission believes Glass-Steagall reform will lead to increased competition in the financial services industry. Without at least the investor protection language contained in the S. 1886 compromise, the Commission most likely would vigorously oppose Glass-Steagall reform.

Now you may wonder why in the world the Commission supports repeal of Glass-Steagall. Well, for starters, we believe that repeal of Glass-Steagall will increase competition in the financial services industry and will make U.S. financial services providers more competitive in world markets. Moreover, investors will be better protected with the S. 1886 compromise

legislation than by continuation of the de facto circumvention and creative regulatory interpretation that has eroded Glass-Steagall. To my mind, it has not been a healthy development for the Commission to lose control over the banking segment of the securities industry -- not healthy, that is, if you want securities regulation to do the job intended by Congress.

IV. Conclusion

These are critically important times in the world's securities markets and for regulators of those markets. There is no shortage of regulatory challenges facing the Commission. Today, I have highlighted two developments presenting such challenges. In addressing current challenges, the Commission continues to be guided by the view that our securities markets must be allowed to evolve if they are to remain healthy.